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Audit risk alert - 2004/05; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Audit Risk Alert—2004/05

Strengthening Audit Integrity
Safeguarding Financial Reporting

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

Notice to Readers

This Audit Risk Alert, prepared by the AICPA staff, is intended to help you identify the significant business risks that may result in the material misstatement of your client's financial statements. This Alert provides CPAs with an overview of recent economic, business, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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How This Alert Helps You

This Audit Risk Alert helps you plan and perform your audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate. This Alert is an important tool in helping you identify the significant business risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and current accounting, auditing, and professional developments.

> **Note**—See the AICPA Audit Risk Alert *Independence and Ethics Alert—2004/05* (product no. 022475kk) for a thorough discussion of recent developments and key issues in the area of independence and ethics.

Understanding the Entity and Its Environment and Assessing Risks

An auditor should obtain an understanding of relevant industry, regulatory, and other external factors. These factors include:

- Industry conditions;
- The regulatory environment encompassing, among other matters, relevant accounting pronouncements;
- The legal and political environment; and,
- Other external factors, such as general economic conditions.

The industry in which the entity operates may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive).

The auditor should obtain an understanding of the entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

After gaining an understanding of the entity and its environment, the auditor needs to make risk assessments at the financial statement and relevant assertion levels based on that understanding.

Presented in this Alert are current business, economic, regulatory, accounting, and auditing matters that may affect your clients. Reading about these matters and properly addressing them as necessary will help you gain a better understanding of your client's environment, will help you better assess risks of material misstatement of the financial statements, and will ultimately strengthen the integrity of your audits.

AICPA Industry Audit Risk Alerts

To help auditors understand the relevant industry factors, regulatory factors, other external factors, and business risks affecting their clients, the AICPA has developed industry-specific Audit Risk Alerts that can be used in conjunction with this Alert. The current list of AICPA Alerts is presented below. Product numbers are listed next to each title. To obtain these Alerts, call the AICPA at (888) 777-7077 or go online at www.cpa2biz.com.

1. Construction Contractors (022315kk)
2. Depository and Lending Institutions (022295kk)
3. Employee Benefit Plans (022414kk)

4. Health Care (022345kk)
5. High Technology (022405kk)
6. Independence and Ethics (022475kk)
7. Insurance Companies (022355kk)
8. Investment Companies (022365kk)
9. Manufacturing (022375kk)
10. Not-for-Profit Organizations (022424kk)
11. Real Estate (022395kk)
12. Securities (022385kk)
13. State and Local Governments (022434kk)

In addition the AICPA publishes the *Compilation and Review Alert—2004/05* (022305kk).

The Present Economy

In planning an audit, an auditor needs to understand the economic conditions facing the client's industry. Economic activities relating to such factors as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and the labor market are likely to have an impact on the entity being audited.

Over the last year, the combined stimulants of easy fiscal and monetary policies contributed to a powerful economic rebound. While the economy experienced greater growth in the third and fourth quarters of 2003, gross domestic product (GDP), which is the broadest measure of economic activity, is still growing at a healthy annual rate. In fact, the United States set a record for yearly production: a GDP of nearly $12 trillion. Moreover, the U.S. financial system is strong and well-positioned, and the stock markets have been enjoying positive growth and gains. U.S. businesses continue to deliver strong results, leveraging the cost cutting and restructuring of the past several years. Operating earnings of companies that comprise the Standard & Poor's (S&P) 500 are up approximately 20 percent over the prior year.

Importantly, the current rise in payrolls alleviates concerns of a jobless recovery. The unemployment rate has turned sharply lower from the peak of 6.4 percent in June 2003. Since August 2003, approximately 1.5 million jobs have been added.

The Federal Reserve has been raising interest rates recently; up from a 46-year low of 1 percent, while stating it intends to raise rates in a measured fashion during what it believes is a self-sustainable economic recovery.

Consumers had more money in their pockets as a result of the effects of the $330 billion tax-cut package passed in May 2003 and 40-year-low interest rates that gave rise to a strong housing market which enabled consumers to tap into home equity lines of credit and refinance mortgages.

Overall consumer spending has been generally positive, and retailers are cautiously optimistic about sales in the coming months. Business spending, while improved, is best described as cautious. Businesses continue to primarily focus on core activities such as improving financial controls and strengthening balance sheets. However, there are positive signs that businesses are beginning to increase capital spending at a time when consumer spending is showing signs of slowing. To help businesses, in October 2004 President Bush signed into law the American Jobs Creation Act (AJCA). The sweeping changes in this overhaul of corporate tax law provide tax relief to domestic manufacturers and multinational corporations.

Economists are predicting steady growth for the U.S. economy, a growth rate expected to be more than twice as fast as Europe. Headwinds for the U.S. economy consist of geopolitical concerns, terrorism, high energy prices, inflation, and rising interest rates.

Top Three Risks Threatening Businesses

A recent survey of chief financial officers polled in Duke University's CFO Outlook indicated the following top three risks that could affect U.S. companies in the near term:

1. Domestic terrorism, which could unhinge consumer confidence
2. Rising interest rates, which could dampen earnings growth and slow capital spending
3. Wage increases, which could greatly increase expenses and drain earnings

Present Business and Economic Developments

Outsourcing

American businesses are increasingly outsourcing various and more sensitive business functions, primarily to remain competitive and improve profit margins. Outsourced functions include information technology, finance, accounting, data entry, transaction processing, telemarketing, manufacturing, tax preparation, investment research, human resources, and call center operations.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Transactions that affect the financial statements are subjected to controls that are, at least in part, physically and operationally separate. • Less control of business function may occur, resulting in weakened internal control and security over systems. • Training at the entity handling the outsourced work may be inadequate, possibly weakening internal control. • Privacy of customer financial and other personal data may be compromised. The company that outsourced the work is legally responsible. • Management's and auditors' understanding and assessment of internal control may need to encompass controls at service organizations handling the outsourced work. Circumstances may impair that understanding and assessment.	• Consider and comply with the auditing requirements of Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended. • Auditors of public companies and other issuers should consider and comply with Appendix B of PCAOB Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, sec. PC), and the related PCAOB Staff Questions and Answers available at pcaobus.org. • Consider and comply with the auditing requirements of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional*

	Standards, vol. 1, AU sec. 337), and SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), in response to the increased legal risk associated with outsourcing.

Rising Interest Rates

The federal-funds rate had been rising and is projected to continue to rise. These rate increases ripple through the economy and cause other interest rates to rise. Approximately half of all U.S. corporate debt outstanding has floating interest rates. Moreover, trillions of dollars worth of derivatives exist, many of which are based on interest rates.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Entities that have issued floating rate debt may see their profit squeezed and their stock and corporate bond prices suffer as interest rates rise. • With a mountain of debt existing in the business sector, rising interest rates can result in losses on derivatives and securities holdings. • Significant changes in and the volatility of general interest rates increase the inherent risk for the valuation of investments and derivatives whose value is significantly affected by interest rates. Remember that in 1994 rising interest rates wreaked havoc on securities holdings and derivatives. History can repeat itself very unexpectedly.	• Rising interest rates may threaten an entity's financial stability and profitability, resulting in an increase in pressure to commit fraudulent financial reporting. If rising interest rates are identified as a fraud risk factor, the auditor will need to develop an appropriate audit response and follow the guidance in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). • If rising interest rates threaten an entity's financial stability and profitability to the point where the auditor believes that it represents a condition that raises a question about the validity of the going concern assumption, then the auditor should follow the guidance contained in SAS No. 59, *An Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), as amended.

- Auditors should carefully understand and follow the guidance in the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, as well as the requirements of SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332).
- Auditors should determine that the method specified by generally accepted accounting principles (GAAP) to determine the value of the investment or derivative is being followed.
- Auditors should determine that the recorded value of the investment or derivative utilizes reasonable interest rates, in those cases in which interest rates affect the valuation of the investment or derivative.
- Auditors of financial institutions should read the AICPA Audit Risk Alert *Bank, Credit Union, and Other Depository and Lending Institution Industry Developments—2004/05* (product no. 022295kk) for guidance about the effects of rising interest rates in that industry.

Rising Earnings, Increased Capital Investment, and Expanding Operations

As the economy and financial conditions continue to improve, earnings are rising at many companies. Small businesses especially are prospering. Moreover, business investment in equipment, facilities, and technology is increasing. If, as projected, the economy continues to post strong gains, many businesses will expand operations and continue to make capital investments and report higher earnings.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Expectations for continued and stronger success grow and the pressure on management to meet those expectations rises as well. Managing earnings can become a real risk as the economy continues to strengthen and a company performs well and is expected to improve its performance. • Management may manipulate earnings and use overly optimistic assumptions when developing estimates under favorable economic conditions. • Management may be tempted to inflate the company's liabilities, allowances, and reserves during prosperous economic times. • Management may be inclined to enter into riskier business and investment decisions during strong economic times. • When operations are expanding: – Management may lack expertise in the new areas. – Management may not properly implement industry-specific accounting principles. – The accounting, operations, and other systems related to the new areas may lack adequate testing and proper integration with core systems. – The client may fail to comply with regulations attendant to the new areas of business.	• Auditors may be inclined to "let their guard down" during periods of economic growth. Auditors should be alert to the potential for management to manage earnings and use overly optimistic assumptions when developing estimates under favorable economic conditions. • Auditors should be alert to management's attempt (1) during healthy economic periods, to "stock the cookie jar," and (2) during weaker economic periods, to reverse those inflated liabilities and allowances and to revert monies back into income. • Auditors may need to review changes in estimates to determine that they are appropriate, timely, and adequately supported with sufficient competent evidential matter. In addition, the company's disclosures need to comply with the requirements of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, regarding the need to disclose material changes in accounting estimates. • As required by Item 303 of Regulation S-K, Securities and Exchange Commission (SEC) registrants should also disclose in Management's Discussion and Analysis (MD&A) changes in accounting estimates that have a material effect on the financial condition or results of operations of the company or trends in earnings, or would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.

- When auditing accounting estimates, auditors should give close attention to the underlying assumptions used by management. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates used in a client's financial statements.
- Practical guidance on auditing estimates is available in the AICPA Audit and Accounting Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk).
- Auditors may want to assess management's level of expertise in the new areas of business and consider that assessment in the determination of audit procedures.
- Auditors may want to inquire about the regulations that exist in new business areas (to the extent necessary to perform a proper audit). Consider the requirements of SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317).
- SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance on internal control.

Raising Capital Through the Equity and Credit Markets

As the economy continues to post strong gains, some signs are appearing that more companies may seek equity and credit financing and the initial public offering (IPO) market may begin to improve. As the stock market continues its upswing, entities gain access to cheaper equity financing.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• For entities seeking to raise capital, high earnings or sales figures are among the most convincing data the entity could present to potential lenders and investors. Accordingly, pressure may exist to inflate revenues and earnings.	• An auditor may decide that additional audit procedures directed to the audit of revenues may be needed to address a possible risk of overstated revenue and earnings. • Auditors may need to focus on management's estimates of future product returns that could have a significant effect on the entity's earnings or sales figures. • Significant revenue recognized toward the close of the latest audited period merits special consideration. Auditors should review the possibility of returns on shipments, the inability of buyers to pay, and contingencies that may prevent revenue recognition. • Chapter 1 of the AICPA Audit Guide *Auditing Revenue in Certain Industries* provides detailed guidance for auditing revenue assertions, including consideration of internal control over revenue recognition, analytical procedures, cutoff tests, vouching, and other substantive tests of details and evaluating accounting estimates relevant to revenue recognition.

Aggressive Assumptions in Pension Plan Accounting and Underfunded Plans

Many companies have been updating and changing the assumptions they use in accounting for pension plans and other postretirement benefit plans to reflect a changing economic environment.

In addition, many companies across all industries are facing a mounting crisis—underfunded pension plans. Simply put, many companies have defined benefit plans in which the obligations owed to retirees exceed the assets in the plans. These companies are faced with pouring large amounts of cash into those plans to meet legal requirements and make up the shortfall. As this crisis worsens, a number of companies are opting to terminate their pension plans.

What Are the Risks or Issues?

- Changes to key assumptions (such as assumed rates of return and discount rates), even small changes, can significantly affect an entity's earnings and financial statements.
- Management can be aggressive in their assumptions and estimates in an attempt to manage earnings and the balance sheet. A recent study conducted by the National Bureau of Economic Research found that some companies hiked pension plan return estimates before making an acquisition or before a top executive exercised stock options.
- The key assumptions used by management in recording accounting estimates related to their company's pension plan and other postretirement plans may be unrealistic and lead to material misstatement in the financial statements.
- Depending on the pension plan, companies with pension plan shortfalls will be confronting losses which will affect earnings, cash flow, and equity. Companies will need to fund their pension plans to meet legal requirements.
- Companies with underfunded pension plans face the risk of technically defaulting on the debt they carry.

What Are Some Auditing Considerations?

- Auditors should be aware that management needs to continually monitor the key assumptions used in measuring pension benefit obligations, returns on plan assets, and periodic service cost. Principal actuarial assumptions include discount rates, participation rates, and factors affecting the amount and timing of future benefit payments. FASB Statements No. 87 and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, indicate that each assumption shall reflect the best estimate solely with respect to that individual assumption on the applicable measurement date.
- When auditing accounting estimates, auditors should give close attention to the underlying assumptions used by management. SAS No. 57 provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates used in a client's financial statements.
- Practical guidance on auditing estimates is available in the AICPA Audit and Accounting Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk).
- Auditors should be aware of this growing problem in the nation's pension plans and may need to consider the financial health of their client's defined benefit plans and determine whether business and audit risks exist, such as a going concern problem.

	• Auditors may need to determine whether disclosure in the financial statements is warranted, based on the pension circumstances at each client. • If activity within an existing plan, such as earnings or returns on invested plan assets, has a material impact on the company's liquidity, capital resources, or results of operations, that activity should be discussed in MD&A.

Mergers and Acquisitions Heating Up

Merger and acquisition activity has been heating up and appears to be making a comeback due to an improving economy and rising stock prices.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Management risks creating deficiencies in internal control and in business operations. • Employees may have an increased opportunity to commit fraud when entities merge. With the shake-ups taking place, employees can take advantage of a breakdown in internal control, a lack of segregation of duties, and missing supervisory reviews to commit fraud. Furthermore, some employees become embittered after a merger, giving them a rationalization to commit fraud. • An entity acquiring another entity may try to worsen the reported financial performance of the purchased company during the period immediately preceding the acquisition date, the *stub period*. By worsening the financial performance of the acquired company before the acquisition, management will find it much	• Auditors may need to re-familiarize themselves with the latest accounting standards (for example, FASB Statement No. 141, *Business Combinations*) relevant to mergers and acquisitions. • Possible gaps and deficiencies in internal control may affect the nature, timing, and extent of audit testing and may represent reportable conditions or weaknesses in internal control that should be communicated to management and the audit committee. Auditors should refer to the guidance set forth under SAS No. 55 as amended. • Auditors should refer to the guidance set forth in SAS No. 99 when assessing the risk of fraud. • Auditors should be on the lookout for "spring loading" types of accounting practices and determine that appropriate GAAP is being followed.

easier to report "improved" performance after the acquisition, thus demonstrating the positive effects of the business combination and providing a pop in reported earnings (known as "spring loading"). This sort of financial engineering may involve the deliberate inflation of reserves and allowances recorded on the acquired company's books. These inflated reserves are then reversed in the period following the acquisition, providing a generous burst of earnings growth.

- Management of public companies may fail to consider the effect of the Sarbanes-Oxley Act and related SEC regulations on the merger. For example, a company may encounter a serious challenge if it acquires a privately-held company that has not had to comply with Sarbanes-Oxley. Necessary internal controls may not be in place at the acquired entity.

- Auditors of public companies need to pay special attention to the proper compliance with Sarbanes-Oxley at the acquired entity and should consider the guidance contained in PCAOB Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, sec. PC).

Information System Attacks and Internal Control

Attacks on corporate information technology (IT) networks are growing exponentially. These attacks take many forms—viruses, distributed denial of service (DDoS), worms, zombie spam, and "phishing" attacks to name some. This is a problem that is not going away any time soon. When assessing internal control, an auditor may need to pay special attention to the client's internal control over IT systems. Given the growing threat to IT systems, management may need to strengthen its information security systems and auditors may find it prudent to focus their attention on the security over IT.

What Are the Risks or Issues?

- Increased access to computer systems could increase the opportunities to change an entity's computer records and those of its trading partners,

What Are Some Auditing Considerations?

- The auditor should be aware of the following when assessing audit risk:
  - Inadvertent disclosure of sensitive information to unauthorized parties

enabling significant fraud to be perpetrated.

- A client's IT systems, especially those more reliant on third parties to ensure security over transactions and continuity of processing, face a number of potential risks, including:
  - Exposure to weak links or unscrupulous individuals
  - Disclosure of confidential information
  - Entry of invalid or unauthorized transactions
  - Incomplete or untimely transmission of data
  - Computer or transmission disruption
  - Hackers and viruses
  - Attempted electronic frauds
- In the course of gathering audit evidence, the auditor should consider the use of computer-assisted audit techniques (CAATs).
- The auditor may want to test control features that deny unauthorized individuals the ability to authorize or initiate a transaction or to change information already in the system.
- The AICPA Auditing Procedure Study *Audit Implications of EDI* (product no. 021060kk) is useful in helping auditors understand the audit implications of IT.

Lease Obligations

In light of the recent accounting scandals related to off-balance-sheet arrangements and hidden debt, auditors are urged to pay careful attention to their clients' lease obligations. Depending upon the accounting treatment, large lease obligations can remain off the balance sheet and disclosed in the notes to the financial statements. Also, the accounting for leases can be complicated.

What Are the Risks or Issues?

- The complicated nature of lease accounting heightens the risk that leases will not be accounted for properly.
- Disclosures about lease obligations and transactions may be inadequate.

What Are Some Auditing Considerations?

- Consider audit planning procedures that will help identify material lease transactions and help determine that the entity is fulfilling its obligations under the leases.
- Review lease contracts to understand the terms. Leasing terms must be evaluated to determine whether the lease should be accounted for as a capital or an operating lease.
- Determine that the requirements of FASB Statement No. 13, *Accounting*

	for Leases, and related pronouncements, are being followed.

Recent Frauds and Earnings Management Techniques

A number of entities have been in the news this past year accused of engaging in fraudulent financial reporting, misappropriation of assets, and inappropriate earnings management activities. Auditors may find it beneficial to become aware of these frauds and earnings management techniques and consider them in light of their own engagements. The tables below assist you in developing audit responses to certain fraudulent activities. Remember that all auditors should have a solid understanding of the requirements of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), and follow those requirements in their audit engagements.

Improper Revenue Recognition

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Management backdating contracts and licensing agreements to improperly record revenue in the wrong quarter or year. • Management engaging in "channel stuffing," the practice of shipping products that are not needed by customers. Channel stuffing without appropriate provision for sales returns is an example of booking tomorrow's revenue today in order to window-dress financial statements. Aggressive channel stuffing may indicate the need to substantially increase the level of anticipated sales returns. • Management recording a sale with a secret arrangement to keep the assets sold, thus improperly recording revenue instead of debt.	• Read and understand the terms of sales contracts to obtain an understanding of what the customer expects and what the company is is committed to provide. In addition, read the contents of the company's sales contract (and sales correspondence) files to uncover evidence of side agreements. • Compare the number of weeks of inventory in distribution channels with prior periods for unusual increases that may indicate channel stuffing. • Compare percentages and trends of sales into the distributor channel with industry and competitors' sales trends, if known. • Compare revenue deductions, such as discounts and returns and allowances, as a percentage of revenues with budgeted and prior period percentages for reasonableness in light of other

revenue information and trends in the business and industry.

- Compare sales credits for returns subsequent to year end with monthly sales credits during the period under audit to determine whether there are unusual increases that may indicate contingent sales or special concessions to customers.
- Analyze the ratio of returns and allowances to sales.
- Review significant year-end contracts for unusual pricing, billing, delivery, return, exchange, or acceptance clauses. Perform post year-end specific review for contract revisions or cancellations and for refunds or credits issued.
- Consider confirming contract terms with the client's customers. Consider confirming with the customer all the significant contract terms, including information about payment terms, right-of-return privileges, acceptance criteria, termination arrangements, or bill-and-hold transactions. Consider the need to confirm with the customer whether there are significant unfulfilled vendor obligations or the existence of any oral or written agreements, particularly with regard to return or termination arrangements, that may alter the terms of the contract. In some circumstances, auditors might also consider contacting major customers orally in addition to written confirmations to determine whether the responses to confirmation requests received appropriate attention from personnel who are knowledgeable about the contract.
- Look at accounts receivable or other accounts to identify significant build-ups in those accounts as a result of the recording of premature or fictitious revenue.
- Look at "Accounts Receivable

	Days," calculated by dividing accounts receivable by revenue per day. Revenue per day is calculated by dividing revenue by 365. Are there substantial, perhaps unsustainable, increases in Accounts Receivable Days that may indicate the recording of premature or fictitious revenue? Also calculate "Quarterly Accounts Receivable Days," by dividing accounts receivable by quarterly revenue per day. Quarterly revenue per day is calculated by dividing quarterly revenue by 91.25.

Understating Expenses and Liabilities

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Management inappropriately deferring expenses and then recording them in later periods. • Management failing to record liabilities related to prepaid dues and repayment obligations.	• Search for unrecorded liabilities and expenses by examining unrecorded invoices and unmatched receiving reports. For a period after the end of the period being audited, examine relevant records such as the cash disbursements journal and the purchases journal. • Assess the reasonableness of recorded expenses by correlating them with appropriate balance sheet amounts and then comparing current ratios to prior periods. • Read minutes of board of directors, shareholders and committee meetings to identify contracts and commitments. • Understand and familiarize yourself with the client's operations to determine whether items such as commissions, various taxes, interest, and other items should be recorded. • Examine contracts, leases, debt agreements, and similar documents for unrecorded liabilities. • Examine unusual or unexplained trends in accounts payable balances and accruals.

Overstating Assets

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Management recording non-existent assets (in particular, cash) on the balance sheet. • Management overstating oil and gas reserves.	• Confirm cash balances with institutions directly. • Examine bank reconciliations. A thorough review of bank reconciliations is one of the best ways of detecting fraud related to cash. • The nature of the oil and gas industry often requires the use of specialists such as reservoir engineers and geologists. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance to the auditor who does use the work of a specialist in performing an audit. • Understand and follow the guidance contained in Auditing Interpretation No. 1, "Supplementary Oil and Gas Reserve Information," of SAS No. 52, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 9558.01–.06), as amended.

Misappropriation of Assets

What are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Management engaging in corporate kleptocracy and receiving unauthorized payments from the company.	• Consider the adequacy of controls over cash disbursements. Do disbursements over a certain dollar amount require dual signature or other control procedure? • Review bank statements and canceled checks. Look at checks made out to employees or to cash. Investigate the propriety of these checks as necessary.

Overstating and Manipulating Liabilities

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Management manipulating accruals and recording overstated ("cookie jar") reserves.	• Evaluate the reasonableness of management's estimates of liabilities and reserves by reviewing and testing the process used and the assumptions made. • Develop an independent expectation about the estimate. • Carefully consider the effects of postbalance-sheet events on the estimation process. • Follow the guidance contained in SAS No. 57.

Practice Aid on Fraud Detection

Guidance related to fraud considerations in a financial statement audit is available from the AICPA Audit and Accounting Practice Aid *Fraud Detection in a GAAS Audit (Revised Edition)* (product no. 006615kk). Call the AICPA at (888) 777-7077 or go online at www.cpa2biz.com to obtain this key resource.

Present Accounting Issues and Developments

> **Note—**See the "New Pronouncements and Other Guidance" section of this Alert for information about recently issued accounting guidance.

Variable Interest Entities and FASB Interpretation No. 46(R)

In December 2003, the FASB issued Interpretation No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*, to incorporate and alter practice issues identified during the implementation of the original interpretation. The interpretation addresses consolidation by business enterprises of entities to which the usual condition of consolidation described in Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, does not apply because the equity investors in an entity either (1) do not have the characteristics of a controlling financial interest or (2) do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. An entity lacking one of these characteristics is referred to as a variable interest entity (VIE). FASB Interpretation No. 46(R) governs how entities should assess interests in other entities in determining whether to consolidate (or deconsolidate) that entity. Auditors should read the full text of FASB Interpretation No. 46(R) and understand its requirements, if the accounting requirements of the Interpretation are relevant.

Related FASB Literature

FASB Interpretation No. 46(R) modifies and/or supersedes portions of many releases by the Emerging Issues Task Force (EITFs), which are located in Appendix F of the standard. Additionally, subsequent to the issuance of the revised interpretation, the following FASB Staff Positions (FSPs) were issued with additional guidance.

- FSP Interpretation No. 46(R)-1—"Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities" (February 12, 2004)

- FSP Interpretation No. 46(R)-2—"Calculation of Expected Losses under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities" (February 12, 2004)

- FSP Interpretation 46(R)-3—"Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities" (February 12, 2004)

- FSP Interpretation 46(R)-4 —"Technical Correction of FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, Relating to Its Effects on Question No. 12 of EITF Issue No. 96-21, 'Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities.'"

Implementation

Under the new guidance, special effective date provisions apply to enterprises that have fully or partially applied the original FASB Interpretation No. 46 before issuance of this revised Interpretation. (See paragraphs 31 and 34 of the revised Interpretation.) Otherwise, application of FASB Interpretation No. 46(R) (or Interpretation 46) is required in financial statements of public entities that have interests in structures that are commonly referred to as special-purpose entities (a subset of variable interest entities), for periods ending after December 15, 2003. Application by public entities, other than small business issuers, for all other types of variable interest entities is required in financial statements for periods ending after March 15, 2004. Application by small business issuers to VIEs other than special-purpose entities and by nonpublic entities to all types of VIEs is required at various dates in 2004 and 2005. In some instances, enterprises have the option of applying or continuing to apply FASB Interpretation No. 46 for a short period of time before applying the revised Interpretation. For investment companies that are subject to SEC Regulation S-X, Rule 6-03-c-1, the effective date is deferred (see paragraph 36 of FASB Interpretation No. 46(R)).

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Accurately applying the guidance in FASB Interpretation No. 46(R) can be challenging. • Determining whether an entity is a VIE, identifying the primary beneficiary, and computing an entity's expected losses and expected residual returns can be difficult and may rely heavily on the use of management judgment. • The Interpretation requires an assessment of every relationship between an enterprise and another legal entity.	• Depending on the circumstances, auditors may need to gain a solid understanding of FASB Interpretation No. 46(R) and engage specialists if the need arises. • Auditors may need to assess whether the entity has complied with the requirements of FASB Interpretation No. 46(R). • The auditor may need to determine whether the substantive differences between the original standard and its revision have been properly applied, including the new transition rules.

- Auditors of primary beneficiaries may need to audit financial statements or material accounts of VIEs. One should plan for the audits of potential entities as early as possible.
- Auditors may need to pay particular attention to the completeness of management's assessment of relationships between an enterprise and another legal entity. Swap agreements and derivative instruments between entities, equity method investments, leases, real estate limited partnerships, and other arrangements and relationships may need to be evaluated.

EITF Issue No. 03-1—New Guidance on Impairment

To answer questions on evaluating other-than-temporary impairment, the FASB issued EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The project included two stages. The first, a disclosure stage, included additional numerical and narrative disclosures for debt and marketable equity securities that have unrealized losses, with an effective date of December 31, 2003, for securities accounted for under FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, and December 31, 2004, for additional securities within the scope. The second stage included accounting guidance that is effective for reporting periods beginning after June 15, 2004.

The EITF's application guidance is described in paragraphs 6 through 20:

Step A: Determine whether an investment is impaired. Is its fair value less than cost? Cost equals amortized cost less any previous write-downs.

Step B: The hard part. Determine whether impairment is other than temporary. Note that the impairment does not have to be permanent to be considered other than temporary.

1. If the fair value of equity securities (including cost method investments) and certain debt securities[1] is less than its carrying amount, the impairment should be deemed other than temporary unless:
   a. The organization has the ability and intent to hold the investment for a reasonable period of time sufficient for a forecasted recovery of fair value up to (or beyond) the cost of the investment; and

   b. Evidence indicating that the cost of the investment is recoverable within a reasonable period of time outweighs evidence to the contrary.

1. Debt securities that can contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of the cost.

2. For all other debt securities, an impairment shall be deemed other than temporary if:
   a. The organization does not have the ability and intent to hold an investment until a forecasted recovery of fair value up to the cost of the investment (which may mean until maturity); or

   b. It is probable the organization will be unable to collect all amounts due according to the debt security's term. In assessing collectibility, the investor should include evidence from rating agencies about fair value fluctuations due to factors other than interest rates.

Step C: Recognize an impairment loss equal to the difference between the investment's cost and its fair value (measured as of the balance sheet date). This clarifies that the write-down should be to fair value rather than recording partial-impairments. Further, the fair value becomes the new cost basis of the investment and should not be adjusted for subsequent recoveries in fair value.

Related Staff Positions Issued

The FASB has issued two FSPs related to EITF Issue No. 03-1. Final FSP EITF Issue No. 03-1-1, "Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1, 'The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,'" delays the recognition and measurement guidance contained in paragraphs 10 through 20. Proposed FSP EITF Issue No. 03-1-a, "Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1, 'The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,'" evaluates interest rate impaired debt securities analyzed under paragraph 16 of EITF Issue No. 03-1.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Other-than-temporary impairments may not be properly accounted for and reported. • The requirements of EITF Issue No. 03-1 will not be properly applied. • The requirements of SEC Staff Accounting Bulletin (SAB) No. 59, *Accounting for Noncurrent Marketable Equity Securities* (Topic 5M), will not be properly applied.	• Auditors may need to understand the requirements of EITF Issue No. 03-1 and SAB No. 59 and determine whether management has complied with those requirements. • When looking at management's classification of investments, remember that the classification, which must occur at acquisition or origination, should be consistent with the entity's investment, asset/liability, and other risk management policies. • The auditor may need to consider management's analysis of the severity and duration of the impairment in accordance with final guidance when determining whether there is sufficient evidence indicating a recovery of fair value up to (or beyond) the carrying amount of the investment. • If impairment is other than temporary, the auditor should note that an impairment loss should be recognized equal to the difference between the investment's carrying amount and its fair value at the balance sheet date of the reporting

period for which the assessment is made. The fair value of the investment would then become the new cost basis of the investment and should not be adjusted for subsequent recoveries in fair value.

Expensing Stock Options

Although most companies do not expense stock options, a growing number of companies are adopting the requirements of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and expensing their stock options. The effect on a company's financial statements of expensing stock options could be significant. Data suggests that approximately 20 percent of reported earnings of many corporations would be erased if they had expensed their stock options.

Proposed FASB Statement, *Share-Based Payment—an amendment of FASB Statements No. 123 and 95*

The FASB has proposed a Statement that would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and generally would require instead that such transactions be accounted for using a fair-value-based method. In October 2004, the FASB approved a six-month delay in the options expensing rule, to June 15, 2005. This accounting proposal is engulfed in highly charged political debate and as such the ultimate resolution of share-based compensation accounting remains uncertain. See the FASB Web site at www.fasb.org for complete information.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• The requirements of FASB Statement No. 123 are not properly applied. • Given the complicated nature of the accounting, management can manipulate stock option expense to help manage the bottom line. • Valuing stock options involves complicated measurement, assumptions, and management judgment.	• Auditors may need to understand the requirements of FASB Statement No. 123 and determine whether management has complied with those requirements. • When auditing accounting estimates, auditors should give close attention to the underlying assumptions used by management.

SAS No. 57 provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates used in a client's financial statements.

- Practical guidance on auditing estimates is available in the AICPA Audit and Accounting Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk).
- Auditors should understand and comply with the requirements of SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 328).

Implementing FASB Statement No. 150

Auditors and client management may need to determine that the requirements of FASB Statement No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity*, have been complied with. Auditors need to talk to their clients about the provisions of FASB Statement No. 150 and clients need to communicate with their bankers and others about the financial reporting implications of the new Statement.

Brief Summary of Accounting Provisions

Note: The FASB has indefinitely delayed the effective date for certain provisions of FASB Statement No. 150 that deal with mandatorily redeemable financial instruments.

FASB Statement No. 150 requires an entity to classify the following instruments as liabilities (or assets in some circumstances):

- A financial instrument issued in the form of shares that is mandatorily redeemable—that embodies an unconditional obligation requiring the issuer to redeem it by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur

- A financial instrument other than an outstanding share that, at inception, embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and that requires or may require the issuer to settle the obligation by transferring assets (for example, a forward purchase contract or written put option on the issuer's equity shares that is to be physically settled or net cash settled)
- A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares, if, at inception, the monetary value of the obligation is based solely or predominantly on any of the following:
  a. A fixed monetary amount known at inception, for example, a payable settleable with a variable number of the issuer's equity shares
  b. Variations in something other than the fair value of the issuer's equity shares, for example, a financial instrument indexed to the S&P 500 and settleable with a variable number of the issuer's equity shares
  c. Variations inversely related to changes in the fair value of the issuer's equity shares—for example, a written put option that could be net share settled

The requirements of FASB Statement No. 150 apply to issuers' classification and measurement of freestanding financial instruments, including those that comprise more than one option or forward contract. The above section is only a brief summary of the provisions of FASB Statement No. 150. Auditors should obtain and read the complete Statement.

Related FASB Staff Positions and EITF Issues

As of the writing of this Alert, four FSPs have been issued related to FASB Statement No. 150. Depending on the circumstance at your client, you may need to become familiar with the guidance in these FSPs. The FSPs can be accessed at www.fasb.org/fasb_staff_positions/final_fsp.shtml, and they are:

- FSP FAS 150-1, *Issuer's Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Contract Embodying Obligations Under FASB Statement No. 150*
- FSP FAS 150-2, *Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount That Differs From the Book Value of Those Shares, Under FASB Statement No. 150*
- FSP FAS 150-3, *Effective Date and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities of FASB Statement No. 150*
- FSP FAS 150-4, *Issuers' Accounting for Employee Stock Ownership Plans Under FASB Statement No. 150*

In addition to the FSPs, a number of EITF Issues are affected by FASB Statement No. 150. A list of them can be found at www.fasb.org/eitf/eitf_affected_by.shtml.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• The requirements of FASB Statement No. 150 are not properly applied. • Implementation of FASB Statement No. 150 may increase reported debt on the financial statements, which could affect debt covenants and other agreements with investors, creditors, and others.	• Auditors may need to understand the requirements of FASB Statement No. 150 and determine whether management has complied with those requirements. • Auditors may need to examine the effect compliance with FASB Statement No. 150 has on the client's debt covenants and other agreements.

New Pension Disclosures—FASB Statement No. 132(R)

In December 2003, the FASB issued revised FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits—an Amendment of FASB Statements No. 87, 88, and 106*. FASB Statement No. 132(R) applies to defined benefit pension plans and other postretirement benefits. It does not apply to defined contribution or multiemployer plans. The Statement does not alter how entities measure or recognize postretirement benefit obligations. It does require additional disclosures about pension plans and other postretirement benefits. Readers should read the full text of the Statement to understand the new disclosure provisions.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Annual and quarterly financial statement disclosures about pension plans and other postretirement benefits will be inadequate and fail to comply with FASB Statement No. 132(R).	• Auditors may need to understand the requirements of FASB Statement No. 132(R) and determine whether management has complied with those requirements. • Auditors may need to pay special attention to a client's annual and quarterly pension and postretirement benefit disclosures and determine whether they comply with FASB Statement No. 132(R).

Revenue Arrangements With Multiple Deliverables

Numerous entities need to comply with the requirements of FASB EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. Many companies offer multiple solutions to their customers' needs. Those solutions may involve the delivery or performance of multiple products, services, or rights to use assets, and performance may occur at different points in time or over different periods of time. In these situations, accounting for the revenue related to those terms can be complicated.

EITF Issue No. 00-21 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. In applying this Issue, separate contracts with the same entity or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and should, therefore, be evaluated as a single arrangement in considering whether there are one or more units of accounting.

That presumption may be overcome if there is sufficient evidence to the contrary. This Issue also addresses how arrangement consideration should be measured and allocated to the separate units of accounting in the arrangement. Readers should refer to the full text of the Issue to understand all of its requirements.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Management may not be aware of the requirements of EITF Issue No. 00-21, may fail to comply with the Issue, or may improperly implement the requirements of the Issue. • The financial statements may not present the disclosures required by EITF Issue No. 00-21.	• Auditors may need to understand the requirements of EITF Issue No. 00-21 and determine whether management has complied with those requirements. • Auditors may need to pay special attention to a client's financial statement disclosures and determine that they properly present the disclosures required by EITF Issue No. 00-21.

Off-Balance-Sheet Setups (SEC FR-67)

Auditors are reminded that public companies must comply with the SEC's final rule about disclosures of off-balance-sheet arrangements. SEC FR-67 (Rel. No. 33-8182), *Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, requires a registrant to provide an explanation of its off-balance-sheet arrangements in a separately captioned subsection of the Management's Discussion and Analysis (MD&A) section of a registrant's disclosure documents. The amendments also require registrants (other than small business issuers) to provide an overview of certain known contractual obligations in a tabular format. This SEC rule can be obtained at www.sec.gov/rules/final/33-8182.htm.

Accounting for CoCos

Be aware of FASB EITF Issue No. 04-8, *The Effect of Contingently Convertible Instruments on Diluted Earnings per Share*. The accounting requirements of this Issue will affect the accounting for contingently convertible debt instruments like contingent convertible bonds (CoCos). Unlike a standard convertible bond, which an investor can exchange for stock at a fixed price when it makes sense, CoCos can be converted only when the stock price reaches a certain target. This loophole allows the CoCos not to get factored into diluted earnings per share until the stock price reaches the target. As such, CoCos are popular because companies gain inexpensive financing and delayed EPS dilution.

EITF Issue No. 04-8 would require that companies record an increase in shares outstanding on the day the CoCos are issued, thereby reducing EPS. As of the writing of this Alert, no final consensus on this Issue has been reached and its provisions are not yet effective. Auditors should be alert to the final resolution of EITF Issue 04-8 and if the Issue becomes effective, determine whether their clients have complied with its provisions.

Proposed Guidance on Exchanges of Assets and Earnings Per Share—Effective Dates Alert

Be aware that the FASB is expected to issue certain Statements at the end of 2004. One of those proposed Statements is *Exchanges of Productive Assets—an amendment of APB Opinion No. 29*. If issued as proposed, the provisions of the final Statement will be effective on a prospective basis for nonmonetary asset exchanges in fiscal years beginning after December 15, 2004. Also, the proposed Statement, *Earnings per Share—an amendment of FASB Statement No. 128*, is proposed to be effective for interim and annual periods ending after December 15, 2004. See the FASB Web site at www.fasb.org and the "On the Horizon" section of this Alert for more information.

Accounting for Receivables From Owners

In audited, reviewed, and compiled financial statements, seeing receivables from owners reported as assets is not uncommon. In fact, most of these receivables should be reported as contra-equity accounts. These receivables, in many cases, simply are recorded as assets, rather than reductions in equity, because of the "tax issue" associated with distributions in excess of basis. Practitioners should refer to EITF Issue No. 85-1, *Classifying Notes Received for Capital Stock*, for guidance about the proper accounting for these balances.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• The financial statements may be materially misstated if receivables from owners are reflected as assets. Generally, with few exceptions, these kinds of receivables should be reflected as a reduction of equity.	• Auditors may need to understand the requirements of EITF Issue No. 85-1 and determine that the client's financial statements comply with those requirements. • Given the nature of these transactions, the auditor may need to gain an understanding of the business rationale for such transactions and whether that rationale (or lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

GAAP Departures Related to EITF Issue No. 95-22

Recent PCAOB inspections of accounting firms have identified a failure in some cases to comply with the requirements of EITF Issue No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*. The provisions of EITF Issue No. 95-22 require that balances under revolving lines of credit be classified as current liabilities of the borrower if the loan agreements contain both a subjective acceleration clause and a requirement to maintain a lock-box arrangement for customer remittances whereby remittances from the borrower's customers immediately reduce the outstanding obligation. In certain cases, the PCAOB found that such debt was incorrectly classified as a long-term liability. Auditors may need to pay special attention to their client's debt and determine that, if such debt meets the criteria of EITF Issue No. 95-22, it is correctly classified as a current liability.

Present Auditing Issues and Developments

> **Note—**See the "New Pronouncements and Other Guidance" section of this Alert for information about recent auditing guidance.

Check 21

The Check Clearing for the 21st Century Act, effective October 28, 2004, gives substitute checks the same legal validity as the original paper checks. Substitute checks are paper reproductions of checks that include an image of the front and back of the original check, and can be processed just like the original check. The Act is intended to reduce the check payment system's dependence on the physical transportation of checks and to streamline the collection and return process. More information on the Act, including Frequently Asked Questions, can be found at www.federalreserve.gov/paymentsystems/truncation/default.htm.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• The new Act does not specify what must be returned to the customer. That decision is left up to the bank. • Detecting check fraud may be more difficult as a result of the Act. Proving alterations and forgeries may become more difficult if there is no access to the original paper and ink which can provide important clues such as pressure points. • Internal controls over cash may need to be reevaluated and revised. • The risk of misappropriation of cash may increase.	• Since the original check will no longer be available, in planning an audit engagement, auditors should be aware of the Act and consider what changes they may need to make in their audit procedures. Both auditors and their clients should be prepared to have these discussions during audit planning. • Because of the range of delivery options, understanding what a clients' financial institution will return should be a top priority for auditors. • Since the Act specifically states that the substitute check has all the force and effect of the actual cleared check, auditors may use a substitute check as evidential matter. In certain cases, an electronic check image will suffice depending upon an auditor's judgment and his or her assessment of fraud risks.

- Auditors will not be able to test the raising of the check payee and the amount. That will likely need to be tested from a control standpoint.
- Audit procedures that can be used in response to an increase risk of misappropriation of cash include:
  – Thoroughly examine bank reconciliations.
  – Obtain a bank cut-off statement that is delivered directly to the auditor.
  – Make sure all canceled checks are accounted for.
  – Look for checks made out to cash or to employees.

Ethics Interpretation 101-3 and Management Representation Letters

AICPA revised Ethics Interpretation 101-3, "Performance of Nonattest Services" (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05), modifies the practitioner's responsibilities for maintaining independence when providing nonattest services (for example, tax or consulting services) to attest clients. This Interpretation is important and should be thoroughly understood by practitioners. Refer to the *Independence and Ethics Alert—2004/05* (product no. 022475kk) for further information. The Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Ethics Interpretation 101-3 provides that if the client lacks the competence to understand certain functions necessary to generate GAAP financial statements, such as developing and posting certain journal entries, the auditor cannot develop and post those journal entries (or perform certain other functions) because doing so would impair the auditor's independence. Accordingly, in such situations management may hire a third party (other than the auditor) to perform those tasks to generate GAAP financial statements. This situation may result in unintended consequences and many auditors may be unaware of these consequences.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• In circumstances in which management lacks the competence to understand certain functions necessary to generate GAAP financial statements, management likely would be unqualified to represent that the financial statements are prepared in conformity with GAAP. The third-party CPA handling the functions that management lacked the competence to perform may fail to sign the management representation letter. • The third-party CPA, making representations to the auditor in the management representation letter, may not clearly communicate the scope of his or her services. • In circumstances in which a third-party CPA is signing the management representation letter using wording representing that he or she believes the financial statements are fairly presented in conformity with GAAP, yet making it clear that he or she did not audit the financial statements, that third-party CPA may be issuing a compilation report. If so, the compilation report may fail to state that the third-party CPA is not independent.	• Auditors need to understand and comply with the requirements of SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), as amended. • Auditors may need to ask management to have the third-party CPA that is helping management prepare financial statements sign the management representation letter. • When a third-party CPA signs the management representation letter, his or her scope of services must be clearly communicated. CPAs issuing compilation reports need to understand and comply with the provisions of AICPA Ethics Interpretation 101-3 and disclose a lack of independence in their compilation reports if necessary.

SAS 70 Reports Issued by Non-CPAs

The requirement that public companies undergo an audit of their internal control as well as an audit of their financial statements has led to greater interest in engagements performed under SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324). SAS No. 70 provides guidance to service auditors who perform and report on a service auditor's engagement, and to user auditors who use a service auditor's report in an audit of financial statements.

It has come to the AICPA's attention that in some cases service auditors' engagements are being performed and reported on by consulting organizations that are not licensed CPA firms. SAS No. 70 is intended for use by licensed CPAs. For a user auditor to use a service auditor's report, it must be issued by a licensed CPA. CPAs may not use a report provided by an unlicensed individual or entity. User auditors should be alert to the possibility that a service auditor's report may not have been prepared by a licensed CPA and should consider contacting a representative of an unfamiliar organization to verify that the organization is properly licensed, peer reviewed, and able to provide its peer review report and letter of comments and response. If the organization is unlicensed, CPAs are advised to convey that finding to the state board of accountancy in the state in which the engagement was performed or to their own state board.

Control Gaps Identified as a Result of SOX 404 Compliance Work

As public companies ready their internal control to comply with the provisions of Sarbanes-Oxley Act Section 404, some common internal control weaknesses are being identified. Knowing what those weaknesses are may be helpful to auditors and alert them to possible internal control weaknesses of their clients. Some of those common control weaknesses are identified in the table below.

What Are the Risks or Issues?	*What Are Some Auditing Considerations?*
• Unqualified or inadequate finance staffs • Lack of process control-related documentation • Formal review and approval gaps • Lack of segregation of duties • Control weaknesses associated with accounting estimates	• Based on these control gap findings, an auditor may want to give special consideration to whether these common control gaps exist at his or her client. • As the auditor gains a sufficient understanding of the control environment, he or she may want to pay special attention to determining whether the finance and accounting staffs are competent and adequate. As the auditor gains a sufficient understanding of control activities and the information and communication component of

internal control, he or she may want to pay special attention to the adequacy of internal control documentation, the existence and effectiveness of authorization controls, and how duties are segregated.

- In auditing accounting estimates, the auditor often assesses the reasonableness of the accounting estimate by performing procedures to test the process used by management to make the estimate. If controls over the preparation of accounting estimates and supporting data are weak, the auditor may need to use other methods to assess the reasonableness of the estimate, besides testing management's process.

Companies Changing Auditors at Record Rates

Recent news reports state that companies and auditors are parting at record rates. That being the case, auditors may be more likely to find themselves in either the role of a predecessor or successor auditor this year. SAS No. 84, *Communications Between Predecessor and Successor Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), as amended, provides guidance in communications between predecessor and successor auditors when a change of auditors is in process or has taken place.

SAS No. 84 as amended cites the inquiry of the predecessor as a necessary procedure on the part of the successor auditor. The successor, upon receiving permission from the prospective client, should make specific and reasonable inquiries of the predecessor regarding matters that will assist the successor in determining whether to accept the engagement. AU section 315 elaborates on specific matters that the inquiry should include. The predecessor should respond promptly and fully to the successor's reasonable inquiries. AU section 315 also states that the successor should request the client to authorize the predecessor to allow a review of his or her working papers. Readers should comply with the full text of AU section 315 when an auditor change has occurred.

Secondary CPAs Assisting Management and SAS No. 50 Concerns

In today's environment, primarily driven by independence concerns, an entity often engages a secondary CPA in public practice (or his or her firm) to assist management in various accounting and reporting functions (such as bookkeeping, performing fair value impairment tests, assistance in preparing financial statements and notes, and assistance in preparing regulatory filings). In this role, the secondary CPA may be asked to provide advice on the application of accounting principles or to help management form accounting positions prior to discussions with its auditor. In these situations, the question arises as to whether SAS No. 50, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 625), applies and whether the secondary CPA is required to consult with the continuing accountant.

SAS No. 50 was issued to provide guidance to a reporting accountant when an entity was "opinion shopping." In some of the situations described above, the secondary CPA is not engaged to provide a second opinion and would, in many situations, be in a position to have full access to management and have full knowledge of the form and substance of the transaction, how management has applied similar transactions in the past, and whether this method of accounting has been discussed with the continuing auditor. Consequently, the secondary CPA may be able to overcome the SAS No. 50 presumptive requirement of consulting with the continuing accountant in the audit of a nonissuer. The AICPA is considering issuing a Technical Question and Answer to address this situation for nonissuers and readers should be alert for guidance on this matter.

Important Developments About Auditor Liability and the Acceptance and Continuance of Clients

A Perspective on Audit Malpractice Claims

Volumes have been written about high profile lawsuits filed against CPA firm auditors involving revenue manipulation by client management. However, data on audit malpractice claims for the 22,000 CPA firms insured with Continental Casualty Company (CNA-underwriters of the AICPA Professional Liability Insurance Program) indicate that only 5 percent of all audit claims involve this type of financial statement fraud. An examination of overall audit claims data provides insight into why most audit claims occur and how firms can best protect themselves from them.

Audit services generate approximately 16 percent of the billings of CPA firms insured in the AICPA Program, and 16 percent of total claims volume in the Program. While audit claims occur far less frequently than claims arising from tax practice, which generate almost 60 percent of all AICPA Program claims, audit claims tend to be severe (high cost).

While claims arising from audits of public companies tend to be severe (high cost), they constitute only 5 percent of all claims in the AICPA Program, while claims arising from audits of nonpublic entities constitute 11 percent of all claims. The focus of this examination, therefore, is on audit claims involving nonpublic entities.

Audit claims arise primarily from technical standards violations (63 percent), failure to detect defalcations (20 percent), and failure to include appropriate disclosures on the face of the financial statements or in the footnotes to the financial statements (13 percent). Four percent of claims involved matters of untimely reporting.

Unlike other areas of practice, engagement letters are issued in approximately 85 percent of all audit engagements resulting in claims. In those claims where no engagement letter was issued, the client was a closely held business, an employee benefit plan, or a not-for-profit entity.

Inventory Error

Of the 63 percent of nonpublic entity audit claims that arise from technical standards violations, almost half involve improper inventory valuation. This percentage is much higher in manufacturing industries. The application of professional judgment is a significant factor in valuing inventory and other assets. Practitioners who lack experience with the specific industry of the client can easily make errors in judgment in valuing partially completed products and projects, raw materials, and intangible assets such as goodwill or technology in the research and development state. Errors in valuing obsolete inventory are also common. In many of these claims, the auditor placed undue reliance on the representations of management and failed to perform research to verify the reasonableness of these representations.

> A CPA firm issued unqualified audit reports for three years to a client whose asset-based lending agreement was secured by unsold and pre-sold inventory. Comments in the working papers indicated the auditor had ongoing concerns regarding inventory obsolescence and late booking of returns. At the end of the third year the client's lender initiated foreclosure proceedings to liquidate the assets of the business when it was no longer able to service the debt.
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> The lender sued the directors and officers of the client along with the CPA firm after recovering about half of the outstanding debt in liquidation. The lender alleged that the financial statements for the second year were materially misstated, and that this caused the lender to extend the line of credit despite the fact that the client was in violation of the loan covenants. An expert retained on behalf of the auditor concluded that the inventory was overstated during all three years and that returns were in fact improperly booked.

Accounts Receivable Errors

Inadequate testing and verification of accounts receivables is another common problem area in audit claims. Of the 63 percent of nonpublic entity audit claims that arise from technical standards violations, over one-third involve accounts receivable errors. Too often the auditors accept management representations regarding the collectibility of a particular receivable or class of receivables without adequately examining past collection experience or the reasonableness of management representations in light of market and industry conditions. Expert review often indicates that reserves for bad debt were inadequate and a significant portion of accounts receivable should have been written off in prior periods, resulting in material errors in past and current financial statements.

Additionally, there have been instances where clever CFOs have outsmarted experienced auditors through any number of schemes intended to inflate the value of accounts receivable. These schemes sometimes involve third-party participants in the fraud who intercept and forge confirmations to assist friends and family members in the client firm. This sort of conspiracy is difficult for the auditor to uncover.

While under the professional standards an audit is not normally designed to detect illegal acts (SAS No. 54, AICPA, *Professional Standards*, vol. 1, AU sec. 317.08), trial jurors typically believe that an auditor is a "watchdog" for public interests and the burden falls on defense counsel to establish that the auditor could not have discovered the illegal act during the audit field work. Maintaining appropriate professional skepticism, carefully controlling the confirmation process, and continually assessing the ethics of client management can help auditors minimize the risk of experiencing such claims.

> A CPA firm audited the annual financial statements of a wholesale distributor. The business was sold, and during the field work for the audit the following year, the successor auditor discovered evidence of an embezzlement scheme orchestrated by the CFO of the distributor. The CFO, using his prior background as an auditor, covered up the theft by creating fictitious vendor accounts. The addresses for the vendors were post office boxes rented throughout the region by an accomplice of the CFO. When the auditors sent out confirmations on the accounts receivable, the amounts of the fictitious receivables were verified in the confirmations, which were often sent in by facsimile transmission. The buyer sued the CPA firm, alleging that they relied upon financial statements that were materially misstated, causing them to overpay for the business.

Failure to Detect Defalcations

Twenty percent of all nonpublic entity audit claims allege failure to detect a defalcation. Most of these claims arise from the audits of closely held, not-for-profit, and governmental entities. Despite the fact that the duty of auditors is limited to "...a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud" (SAS No. 1, *Codification of Auditing Standards and Procedures*, AICPA, *Professional Standards*, vol. 1, AU sec. 110.02, "Responsibilities and Functions of the Independent Auditor"), the public at large as well as clients expect auditors to detect embezzlements.

Businesses that have a high volume of cash receipts or that have poor internal controls are particularly susceptible to embezzlement schemes. These schemes typically involve long-term employees stealing inventory or cash in increasing amounts over a long period of time prior to discovery. Clients often seek recovery from the auditor once they discover that their bonding coverage is inadequate to cover the loss and that recovery from the fraudster through the courts is time-consuming, burdensome, and often results in only a partial recovery over an extended time period.

Most audit claims involving failure to detect a defalcation have similar facts. A trusted and long-time employee in an accounting or financial management position typically commits the theft. The theft occurs over three to six years, in increasing amounts during later periods. The increase in amounts stolen typically leads to discovery of the scheme. Amounts claimed range from $100,000 to several million dollars. In approximately 35 percent of these cases the amounts stolen are material to the company's financial statement in one or more years.

> A CPA firm audited the annual financial statements of a manufacturer. While the field work was being performed for one of the audits, the CEO of the client informed the auditors that the company discovered that the CFO had embezzled funds from the firm over a number of years. The CPA firm was sued for failing to detect the embezzlement.
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> The CFO committed the theft by diverting mail containing customer payments and debiting an inventory account to cover up the theft. The company did not maintain a perpetual inventory and the inventory discrepancy went unnoticed for years because production costs fell within an expected range. While the CPA firm could not have detected the theft in the course of performing the audit, the absence of effective inventory

and cost accounting controls constituted a reportable condition. A key issue in the subsequent lawsuit was whether or not the CPA firm adequately reported these problems and made recommendations to firm management to institute appropriate controls.

Inadequate Financial Statement Disclosures

A fourth problem area is failure to include appropriate disclosures on the face of the financial statements or in the footnotes to the financial statements. This was the principal error leading to the loss alleged in 13 percent of all nonpublic entity audit claims. In most circumstances the dispute concerns the classification and disclosure of the nature of a security held by the client firm, such as derivative financial instruments and loans to related parties. An auditor has explicit duties in auditing investments (SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, AICPA, *Professional Standards*, vol. 1, AU sec. 332), and it is difficult to defend claims where the adequacy of disclosures about client investments is in question, especially when the investments are material to the financial statements.

Survey of Jurors' Attitudes Toward CPAs

A recent survey investigating potential jurors' attitudes towards accountants indicated that after the recent corporate scandals participants feel even stronger that CPAs are responsible for policing their clients and discovering fraud. This important survey was conducted by CAMICO Mutual Insurance Company, a provider of professional liability insurance and risk management programs for the accounting profession. The survey can be obtained at www.camico.com/website/press_releases.asp.

Considering the survey results and considering the recent corporate scandals, the need for auditors to know who their clients are is as important as ever. Investigating the integrity of management before agreeing to perform any level of service is essential and avoiding association with unethical management is a good business practice regardless of what the auditor is being hired to do.

New Quality Control Guidance Issued

Key to avoiding unethical clients is establishing a strong quality control system within the CPA firm. The Joint Quality Control Standards Task Force of the Auditing Standards Board (ASB) has published an AICPA Audit and Accounting Practice Aid titled *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Audit Practice.* This Practice Aid supersedes *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, which was issued in 1996. The revisions in the new practice aid incorporate new policies and procedures that a firm should consider including in its system of quality control to be responsive to the changing environment. The revisions also include:

- More specific and detailed guidance, as recommended by the Panel on Audit Effectiveness
- Guidance concerning significant clients
- A new chapter titled, "System of Quality Control for Alternative Practice Structure"
- Certain best practices included in the international quality control standards
- All of the quality control standards (Statements on Quality Control Standards)

You can obtain the Practice Aid (product no. 006623kk) by calling the AICPA at (888) 777-7077 or going online at cpa2biz.com.

New Practice Alert on Accepting and Continuing Client Relationships

The Professional Issues Task Force of the AICPA has issued Practice Alert 2003-3, *Acceptance and Continuance of Clients and Engagements*, to provide practitioners and their firms with guidance regarding the establishment of policies and procedures for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. The Practice Alert can be obtained at www.aicpa.org.

New Pronouncements and Other Guidance

Recent Auditing, Attestation, and Quality Control Pronouncements and Related Guidance

Presented below is a list of auditing, attestation, quality control, and related guidance issued since the publication of last year's Alert. For information on auditing and attestation standards, quality control standards, and related guidance that may have been issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm and the PCAOB Web site at www.pcaobus.org (public company audits only).

You may also look for announcements of newly-issued standards in *The CPA Letter, Journal of Accountancy*, and the quarterly electronic newsletter, "In Our Opinion," issued by the AICPA's Auditing Standards team and available at www.aicpa.org/members/div/auditstd/opinion/index.htm.

SOP 04-1 (November 2004) (Not applicable to audits conducted in accordance with PCAOB standards)	*Auditing the Statement of Social Insurance* This SOP assists CPAs in auditing the statement of of social insurance—a financial statement required by Federal Accounting Standards Advisory Board (FASAB) Statement of Federal Financial Accounting Standards (SFFAS) No. 17, *Accounting for Social Insurance*, and SFFAS No. 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*.
ASB Audit Interpretation No. 17 of SAS No. 58 (June 2004) (Not applicable to audits conducted in accordance with PCAOB standards)	"Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards" This Interpretation provides illustrative language in the auditor's report to clarify that an audit performed in accordance with generally accepted auditing standards (GAAS) does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer for whom Section 404(b) of the Sarbanes-Oxley Act of 2002 is applicable.
ASB Audit Interpretation No. 18 of SAS No. 58 (June 2004) (Not applicable to audits	"Reference to PCAOB Standards in an Audit Report of a Nonissuer" This Interpretation clarifies the applicability of GAAS and provides illustrative language for a dual

conducted in accordance with *only* PCAOB standards)	reference reporting situation when the audit was conducted in accordance with both GAAS and the auditing standards of the PCAOB.
PCAOB Auditing Standard No. 1 (May 2004) (Applicable to audits conducted in accordance with PCAOB standards only)	*References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (See summary in "PCAOB Developments" section below)
PCAOB Auditing Standard No. 2 (June 2004) (Applicable to audits conducted in accordance with PCAOB standards only)	*An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (See summary in "PCAOB Developments" section below)
PCAOB Auditing Standard No. 3 (August 2004) (Applicable to audits conducted in accordance with PCAOB standards only)	*Audit Documentation and Amendment to Interim Auditing Standards* (See summary in "PCAOB Developments" section below)
Conforming Amendments (November 2004) (Applicable to audits conducted in accordance with PCAOB standards only)	*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2.*
PCAOB Rules (Various dates) (Applicable to audits conducted in accordance with PCAOB standards only)	In the past year the PCAOB has issued numerous rules to be used by registered public accounting firms in the preparation and issuance of audit reports. (See summary in "PCAOB Developments" section below)
PCAOB Staff Questions and Answers (Applicable to audits conducted in accordance with PCAOB standards only)	(1) *Auditing Internal Control Over Financial Reporting*. These questions and answers consist of three separate sets—questions 1-26, questions 27-29, and questions 30-36. (2) *Audits of Financial Statements of Non-Issuers Performed Pursuant to the Standards of the PCAOB*
Suggested Framework for Internal Controls Related to PCAOB Auditing Standard No. 2	*A Framework for Evaluating Process/Transaction-Level and Information Technology General Control Exceptions and Deficiencies* Developed by representatives of nine firms and a

	professor, this framework reflects their views on a methodology consistent with their understanding of PCAOB Auditing Standard No. 2. The framework can be obtained at www.aicpa.org/cpcaf/download/framework_v2.pdf.
AICPA Toolkit (December 2003) (nonauthoritative)	*The AICPA Audit Committee Toolkit* This toolkit provides comprehensive advice on audit committee duties such as agenda setting, conducting executive sessions, and evaluating the effectiveness of auditors and the audit committee itself. It also offers basic information on important topics such as internal controls, anti-fraud accountability, and off-balance-sheet transactions.
AICPA Practice Alert 2003-3 (January 2004) (nonauthoritative)	*Acceptance and Continuance of Clients and Engagements* This Practice Alert provides practitioners and their firms with guidance regarding the establishment of policies and procedures for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client.
AICPA Practice Alert 2004-1 (October 2004) (nonauthoritative)	*Illegal Acts* This Practice Alert is intended to guide the auditors of non-issuers with respect to illegal acts.
AICPA Technical Practice Aid 9110.15 (September 2004) (nonauthoritative)	*Reporting on Medicaid/Medicare Cost Reports* This Technical Practice Aid discusses what form of report an auditor should issue to comply with the "certification" requirement from payors in regard to health care organization financial statement audit engagements.
AICPA Audit and Accounting Practice Aid (November 2004) (nonauthoritative)	*Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* This Practice Aid can help practitioners better understand and apply the Statements on Quality Control Standards issued by the AICPA. It contains new policies and procedures that a firm should consider including in its system of quality control to be responsive to the changing environment.
AICPA Audit and Accounting Practice Aid (June 2004) (nonauthoritative)	*Auditing Governmental Financial Statements: Programs and Other Practice Aids* This Practice Aid provides audit programs and other tools to help practitioners conduct their governmental audits in light of the extensive provisions of GASB Statement No. 34 and the new financial reporting model it introduces.

New COSO Framework	*Enterprise Risk Management—Integrated Framework* This document describes the essential components, principles, and concepts of enterprise risk management for all organizations, regardless of size. With heightened concern and focus on risk management, the framework provides boards of directors and managements with a clear roadmap for identifying risks, avoiding pitfalls, and seizing opportunities to grow stakeholder value. This new framework is expected to be widely accepted as the benchmark for dealing with business risk. The framework can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com/store.

As necessary, auditors should obtain and understand the complete text of the applicable standards and other guidance. You should visit the applicable Web site for complete information.

Auditing Standards Available on AICPA and PCAOB Web Sites

The standards and interpretations promulgated by the AICPA Auditing Standards Board are now available free of charge by visiting the AICPA Audit and Attest Standards Team's page at www.aicpa.org/members/div/auditstd/Auth_Lit_for_NonIssuers.htm. Members and nonmembers alike can download the auditing, attestation, and quality control standards by either choosing a section of the codification or an individual statement number. You can also obtain copies of AICPA standards and other guidance by contacting the AICPA at (888) 777-7077 or online at www.cpa2biz.com.

Also, the PCAOB has published its interim standards for audits of public companies on its Web site (www.pcaobus.org) free of charge.

New AICPA Audit Quality Centers Established

Center for Public Company Audit Firms

The AICPA Center for Public Company Audit Firms began operations January 2004, as a voluntary membership organization for firms that audit or are interested in auditing public companies. Following the Sarbanes-Oxley Act's creation of the PCAOB to inspect and discipline auditors of SEC-registered issuers, the AICPA established the center to achieve the following objectives:

- Enhance the quality of member firms' public company audit practices through the timely communication to members of SEC- and PCAOB-related news, the development of technical and educational information for members, and the promotion of best practices.
- Provide a forum for member firms to discuss and express their views on matters that affect public company audits.
- Maintain relationships with member firms and act as a liaison to the SEC and the PCAOB on their behalf.
- Propose to regulators solutions to issues member firms identify, and prepare comment letters on rule proposals that affect public company auditors.
- Administer a peer review program—focused on member firms' private company audit practices—that will bridge the PCAOB's inspection of member firms' public company audit practices.

Additional information on the Center is available at www.aicpa.org/cpcaf.

Employee Benefit Plan Audit Quality Center

Created in March 2004, the AICPA Employee Benefit Plan Audit Quality Center is intended to provide a forum that spurs CPA firms performing audits to make immediate quality improvements to employee benefit audits under the Employee Retirement Income Security Act (ERISA), including pension, health and welfare, and 401(k) plans. In addition to gaining access to best practices, guidelines, and tools focused around quality improvement, members of the Center will be subject to membership requirements that demonstrate the firm's commitment to audit quality in this area. Additional information about the Center can be found at www.aicpa.org/ebpaqc.

Governmental Audit Quality Center

In September 2004, the AICPA launched the Governmental Audit Quality Center, which is designed to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The Center is a voluntary membership center which will give CPA firms the tools they need to adhere to a high standard of quality in conducting governmental audits, including audits of federal, state, and local governments; not-for-profit organizations; and certain for-profit organizations. It will also be a place where firms dedicated to quality governmental audits will share best practices, learn about emerging issues, and take steps to enhance quality in their practices. For more information or to join, visit www.aicpa.org/gaqc.

Recent AICPA Independence and Ethics Pronouncements

The AICPA *Independence and Ethics Alert—2004/05* (product no. 022475kk) contains a complete update on new independence and ethics pronouncements. This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain that Alert to be aware of independence and ethics matters that will affect their practice. In addition to the other matters discussed in *Independence and Ethics Alert—2004/05*, auditors should be aware of these recent issuances by the AICPA Professional Ethics Executive Committee:

- ***Revised AICPA Ethics Interpretation No. 101-3, Performance of Nonattest Services.*** This revised Interpretation modifies the practitioner's responsibilities for maintaining independence when providing nonattest services (for example, tax or consulting services) to attest clients.

- **AICPA Members Who Outsource**—Ethics Ruling No. 112, "Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services," under Rule 102 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.224–.225), and Ethics Ruling No. 12, "Applicability of General and Technical Standards When Using a Third-Party Service Provider," under Rule 201 and Rule 202 (AICPA, *Professional Standards*, vol. 2, ET sec. 291.023–.024). These rulings provide new requirements related to members who outsource certain professional services.

Recent Accounting Pronouncements and Related Guidance

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in *The CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 151 (November 2004)	*Inventory Costs, an amendment of ARB No. 43, Chapter 4* This Statement clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and by requiring the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities.
FASB Statement No. 132 (revised 2003) (December 2003)	*Employers' Disclosures about Pensions and Other Postretirement Benefits—an Amendment of FASB Statements No. 87, 88, and 106* This Statement revises employers' disclosures about pension plans and other postretirement benefit plans by requiring additional disclosures to those in the original FASB Statement No. 132 about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans.
FASB Interpretation No. 46(R) (December 2003)	*Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of Accounting Research Bulletin No. 51* (See summary below)
FASB EITF Issues (Various dates)	Go to www.fasb.org/eitf/ for a complete list of EITF Issues.
FASB Staff Positions (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FASB Staff Positions (FSPs). Some of the recently issued FSPs address issues relating to FASB Statements No. 141, 142, 144, and 150, among others, FASB Interpretations No. 45 and 46(R), and EITF Issue No. 03-1.

SEC Rules, Regulations, Accounting Bulletins, and so on (Various dates)	(See "Securities and Exchange Commission Developments" section below)
AICPA Audit and Accounting Guide (January 2004)	*Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies* This new AICPA Audit and Accounting Guide applies to all banks, savings institutions, credit unions, and finance companies. It also applies to entities that do not consider themselves to be finance companies that engage in transactions that involve lending to or financing the activities of others, and entities that do not consider themselves to be mortgage companies that engage in transactions that involve mortgage activities or transactions. This Guide supersedes the AICPA Audit and Accounting Guides *Banks and Savings Institutions*, *Credit Unions*, and *Finance Companies.*
SOP 03-4 (December 2003)	*Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies, *and AICPA Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships This SOP provides guidance on the application of certain provisions of the AICPA Audit and Accounting Guide *Investment Companies* and AICPA Statement of Position 95-2, *Financial Reporting by Nonpublic Investment Partnerships*, that are directed to the reporting by nonregistered investment partnerships of financial highlights and the schedule of investments. It amends certain provisions of the Guide and SOP 95-2 by adapting those provisions to nonregistered investment partnerships based on their differences in organizational and operational structures from registered investment partnerships.
SOP 03-5 (December 2003)	*Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies This SOP provides guidance on reporting financial highlights by separate accounts of insurance enterprises.

SOP 04-2 (December 2004)	*Accounting for Real Estate Time-Sharing Transactions*
AICPA Audit and Accounting Practice Aid (May 2004) (nonauthoritative)	*Valuation of Privately-Held Company Equity Securities Issued as Compensation* This Practice Aid provides useful information on measuring the cost of such transactions and properly reflecting them in company financial statements.
AICPA Technical Practice Aid 6930.05 (July 2004) (nonauthoritative)	*Sale of Real Estate Investments Held by Employee Benefit Plans and Discontinued Operations*
AICPA Technical Practice Aid 6400.45 (August 2004) (nonauthoritative)	*Applicability of FASB Interpretation No. 45—Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—Physician Loans* This Technical Practice Aid addresses whether physician loans are subject to FASB Interpretation No. 45.
AICPA Technical Practice Aid 6400.46 (August 2004) (nonauthoritative)	*Applicability of FASB Interpretation No. 45—Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—Mortgage Guarantees* This Technical Practice Aid addresses whether mortgage guarantees are subject to FASB Interpretation No. 45.
AICPA Technical Practice Aids 6300.05–.08 (October 2004) (nonauthoritative)	Related to SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*

The summaries provided above are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards and other guidance. You should visit the applicable Web site for complete information. You can obtain copies of AICPA standards and other guidance by contacting the AICPA at (888) 777-7077 or online at www.cpa2biz.com.

Key Regulatory Developments Related to Audits of Public Companies

Public Companies Complying With Sarbanes-Oxley and Related Regulations

The SEC and the Public Company Accounting Oversight Board (PCAOB) have been active in issuing and proposing rules implementing the provisions of the Sarbanes-Oxley Act of 2002. A wealth of information about the provisions of the Sarbanes-Oxley Act is available on the AICPA Web site at www.aicpa.org/sarbanes/index.asp. Visit the SEC and PCAOB Web sites at www. sec.gov and www.pcaobus.org for detailed information about their regulations and standards.

The provisions of the Sarbanes-Oxley Act and the rules of the SEC and the PCAOB generally apply to public companies and the auditors of public companies. Public companies are currently implementing the SEC rules and provisions of the Sarbanes-Oxley Act. This effort is being accomplished at great cost and effort. The magnitude of the effort for public companies and their auditors to comply with all of the rules and standards of the SEC and the PCAOB within the set deadlines is enormous. As such, auditors of public companies need to especially focus on ensuring that they are complying with all of the applicable rules and standards of the PCAOB. In addition, auditors will need to determine that their public company clients are complying with the provisions of the Sarbanes-Oxley Act and the regulations of the SEC.

Three critical areas that public companies must address are (1) complying with Sarbanes-Oxley Section 404 on internal control reporting, (2) complying with Sarbanes-Oxley Sections 302 and 906 certifications, and (3) complying with Sarbanes-Oxley Section 301 on requirements for audit committees. The section below presents an additional discussion about complying with Sarbanes-Oxley Section 404.

Complying With Sarbanes-Oxley Section 404—Internal Control Reporting

Beginning in 2004, many publicly traded companies must comply with new SEC rules issued under Section 404 of the Sarbanes-Oxley Act and include in their annual reports (Forms 10-K or 10-KSB) a discussion of the effectiveness of their internal control over financial reporting. The SEC's rules implementing Section 404 can be obtained at www.sec.gov/rules/final/33-8238. htm.

The internal control report must include (1) a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company, (2) management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, (3) a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting, and (4) a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting. Under the new rules, a company is required to file the registered public accounting firm's attestation report as part of the annual report.

Furthermore, the SEC added a requirement that management evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Effective Date Information

A November 15, 2004, effective date applies to "accelerated filers," which generally are companies whose market value exceeds $75 million. Nonaccelerated filers and foreign private issuers have until July 15, 2005, to file their first internal control report. On November 30, 2004, the SEC issued an Exemptive Order (Release No. 50754) to grant certain accelerated filers that have a fiscal year ending between and including November 15, 2004, and February 28, 2005, and that had a public equity float of less than $700 million at the end of their second fiscal quarter in 2004 up to an additional 45 days to include in their annual reports management's report on internal control over financial reporting and the related auditor's report on management's assessment of internal control over financial reporting. This Order can be viewed at www.sec.gov/rules/exorders/34-50754.htm. In addition, the SEC is considering a four-month extension of the effective date for nonaccelerated filers and foreign private issuers. Readers should be alert to any final issuances by the SEC on this matter.

SEC Staff Questions and Answers

The SEC staff has answered frequently asked questions about management's report on internal control over financial reporting and disclosure in Exchange Act Periodic Reports. These questions and answers are available at www.sec.gov/info/accountants/controlfaq0604.htm.

Some Key Points to Remember About Section 404

- The Sarbanes-Oxley Act does not specify an internal control framework to use when making management's assessment on internal control. However, the COSO Framework is the best known and is widely available. You can obtain the COSO Framework by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.
- Management's report must address not just the design of controls, but also their operating effectiveness. Thus, testing of controls must be performed by management.
- The nature of a company's testing activities depends largely on the company's circumstances, the type of control involved, and the significance of such control to the company's financial reporting.
- In developing its assessment of internal control over financial reporting, a company must maintain evidential matter, including documentation, to provide reasonable support for the assessment.

Challenges When Complying With Sarbanes-Oxley 404

Management will find preparing the internal control report a challenge, particularly when there are internal control deficiencies. A recent survey conducted by Jefferson Wells and the Institute of Internal Auditors indicated that the most significant challenges related to Sarbanes-Oxley compliance include:

- Insufficient resources
- Documentation issues
- Communication issues
- Lack of definitive standards
- Size or geographic reach of the organization
- Lack of guidance from external auditors
- Controls identification and testing
- Cost of the project

Disturbingly, this survey found that 13 percent of respondents indicated that their companies had not communicated at all with their external auditors about Sarbanes-Oxley.

Material Weaknesses in Internal Control May Not Result in Severe Regulatory Reaction. As public companies comply with the provisions of Sarbanes-Oxley Section 404, material weaknesses in internal control are being identified. The SEC's Chief Accountant recently stated that as public companies announce the existence of material weaknesses, they, by themselves, should not necessarily lead to severe regulatory or investor reactions. He advised that material weaknesses be fully disclosed and that management correct any weaknesses in their systems.

Considerations for Auditors of Public Companies

Standard to Follow When Reporting on Management's Assessment of Internal Control. As stated above, public companies must have their auditors issue a report on management's assessment of the company's internal control over financial reporting. The PCAOB has issued Auditing Standard No. 2, *An Audit of*

Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements (AICPA, *Professional Standards*, vol. 1, sec. PC), which provides guidance and requirements for auditors to perform that audit and issue a report on management's assessment of the company's internal control over financial reporting. Moreover, the PCAOB has issued and subsequently updated staff questions and answers titled, *Auditing Internal Control over Financial Reporting*, which is available at the PCAOB Web site (www.pcaobus.org).

On November 30, 2004, the PCAOB adopted a transitional rule that will temporarily relieve auditors from two provisions of PCAOB Auditing Standard No. 2 in connection with audits of companies that rely on the SEC's Exemptive Order, described under the "Effective Date Information" section above. See the "PCAOB Developments" section below for further information.

Getting Involved in Management's Process. Complying with the requirements of Sarbanes-Oxley Section 404 is a major project for public companies. They are assessing their control environment, systems capabilities, and basic accounting practices; identifying and documenting significant controls; evaluating the controls; documenting the test results; evaluating and correcting deficiencies; and ultimately preparing a report. Given the scope and importance of this project, the auditor should be involved in the process. The auditor and management should communicate with one another about Section 404 compliance activities on a regular basis. Management may want to confirm its approach with the auditor and determine whether the body of documentation and evidence it plans to accumulate during its assessment process is acceptable to the auditor.

Auditor Independence Concerns. The Sarbanes-Oxley Act and the SEC rules implementing Section 404 of the Sarbanes-Oxley Act require the auditor to be independent to perform an audit of internal control over financial reporting. Under the SEC's Rule 2-01 on auditor independence, an auditor impairs his or her independence if the auditor audits his or her own work, including any work on designing or implementing an audit client's internal control system. PCAOB Auditing Standard No. 2 explicitly prohibits the auditor from accepting an engagement to provide an audit client with an internal control-related service that has not been specifically pre-approved by the audit committee. That is, the audit committee cannot pre-approve internal control-related services as a category, but must approve each service. The SEC's independence rules would prohibit the company from relying on its auditors to perform the evaluation of the effectiveness of internal controls. An auditor may assist with the work but management must continue to make all final decisions, exercise its own judgment in performing the analysis, and be in charge of the work being done.

A Framework for Evaluating Process/Transaction-Level and Information Technology General Control Exceptions and Deficiencies Resulting From the Evaluation of Internal Control Over Financial Reporting

A framework for evaluating manual and automated process/transaction-level and information technology general control exceptions and deficiencies resulting from the evaluation of internal control over financial reporting has been developed by representatives of nine CPA firms and a professor at Georgia State University. This paper should be read in conjunction with PCAOB Auditing Standard No. 2, especially the definitions in paragraphs 8 through 10, the section on evaluating deficiencies in paragraphs 130 through 141, the examples of significant deficiencies and material weaknesses in Appendix D, and the Background and Basis for Conclusions in Appendix E. The framework is not a substitute for PCAOB Auditing Standard No. 2 and other relevant professional literature. The framework can be obtained at www.aicpa.org/cpcaf/download/framework_v2.pdf.

Securities and Exchange Commission Developments

Auditors of public companies and of those companies that file with the SEC need to consider the accounting and financial reporting requirements contained in the SEC regulations as well as requirements imposed upon auditors. Listed below are some recent activities of the SEC to help auditors of public companies stay abreast of current developments. The summaries below are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable rule. See the SEC Web site at www.sec.gov for complete information.

SEC Staff Accounting Bulletins

SAB No. 104 (December 2003)	*Revenue Recognition* This SAB updates portions of the interpretative guidance included in Topic 13 of the SEC's codification of SABs to make it consistent with current authoritative accounting guidance. The SAB's principal revisions relate to the rescission of material no longer necessary because of private-sector developments in U.S. GAAP.
SAB No. 105 (March 2004)	*Application of Accounting Principles to Loan Commitments* This SAB adds section DD, "Loan Commitments Accounted for as Derivative Instruments," to Topic 5, "Miscellaneous Accounting," of the SEC's codification of SABs. The new section provides interpretative guidance SEC-registered companies should consider when recognizing such commitments, and it emphasizes certain disclosure requirements that may be relevant to mortgage banking activities.
SAB No. 106 (September 2004)	Section 4, "Interaction of Statement 143 and the Full Cost Rules," under Topic 12-D, "Oil and Gas Producing Activities—Application of Full Cost Method of Accounting" The interpretations in this SAB express the staff's views regarding the application of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, by oil and gas producing companies following the full cost accounting method. The SAB, which adds Section 4 to Topic 12-D of the SAB series, deals with the impact of FASB Statement No. 143 on the full cost ceiling test and on the calculation of depreciation, depletion, and amortization.

SEC Final Rules and Orders

The recent SEC final rules and orders are too numerous to list in this Alert. Presented below are the newly issued rules and orders that are most relevant to accounting and auditing. Refer to the

SEC Web site at www.sec.gov/rules/final.shtml for a comprehensive list of final rules.

Release No. 33-8392 (February 2004)	*Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* This rule extends the compliance date for requirements regarding the evaluation of internal control over financial reporting and management certification requirements, including certification and related requirements applicable to registered investment companies.
Release No. 33-8400 (May 2004)	*Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date* This rule expands the number of events that are reportable on Form 8-K under the Securities Exchange Act of 1934. The amendments add eight new items to the form, transfer two items from the periodic reports, and expand disclosures under two existing Form 8-K items. The amendments also shorten the Form 8-K filing deadline for most items to four business days after the occurrence of an event triggering the disclosure requirements of the form.
Release No. 33-8400A (August 2004)	*Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date: Correction* This release makes technical corrections to rules adopted in Release No. 33-8400 (see above).
Release Nos. 33-8507; 34-50684 (November 2004)	*Temporary Postponement of the Final Phase-in Period for Acceleration of Periodic Report Filing Dates* This Rule postpones, for one year, the final phase in period for acceleration of periodic report deadlines that apply to larger companies known as "accelerated filers." For an additional year the deadline for accelerated filers will remain at 75 days after year end for annual reports and at 40 days after quarter end for quarterly reports.
Exemptive Order No. 34-50754 (November 2004)	*Order Under Section 36 of the Securities Exchange Act of 1934 Granting an Exemption from Specified Provisions of Exchange Act Rules 13a-1 and 15d-1* This Order grants certain accelerated filers up to an additional 45 days to include in their annual reports management's report on internal control over financial reporting and the related auditor's report on management's assessment of internal control over financial reporting.

SEC Interpretative Releases

Release No. 33-8350 (December 2003)	*Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations* This guidance emphasizes Management's Discussion and Analysis (MD&A) should not be merely a recitation of financial statements in narrative form or otherwise uninformative technical responses, neither of which provides the important management perspective an MD&A should offer. Instead the release encourages top-level management to participate in drafting the MD&A and provides guidance regarding the overall presentation and focus of MD&A.
Release No. 33-8422 (May 2004)	*Commission Guidance Regarding the Public Company Accounting Oversight Board's Auditing and Related Professional Practice Standards No. 1* This guidance directs auditors to cease referring to generally accepted auditing standards (GAAS) in audit reports relating to corporate financial statements and to refer instead to the standards of the PCAOB. The guidance in this release is applicable only to auditors' engagements that are governed by PCAOB rules.

SEC Frequently Asked Questions Related to Sarbanes-Oxley Section 404

The SEC staff has issued answers to frequently asked questions, titled *Management's Report on Internal Control over Financial Reporting and Disclosure in Exchange Act Periodic Reports*. The questions and answers are available at www.sec.gov/info/accountants/controlfaq0604.htm.

PCAOB Developments

As a result of the Sarbanes-Oxley Act of 2002, both U.S. and non-U.S. public accounting firms wishing to prepare or issue reports on U.S. public companies, or to play a substantial role in the preparation or issuance of such reports, must be registered with the PCAOB and comply with the standards and rules of the PCAOB. The PCAOB's standards and rules apply to registered public accounting firms and their associated persons in connection with their audits of the financial statements of issuers, as defined in Section 2(a)(7) of the Sarbanes-Oxley Act, and those firms' auditing and related attestation practices. The PCAOB does not intend to suggest that registered public accounting firms and their associated persons must comply with the PCAOB's standards and rules in auditing nonissuers. Auditors who fall within the PCAOB's scope should understand and follow the standards, rules, and other requirements of the PCAOB. All PCAOB standards and rules must be approved by the SEC prior to taking effect.

Newly Approved Standards

PCAOB Auditing Standard No. 1 (May 2004)	*References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* This standard requires that auditors' reports on engagements conducted in accordance with PCAOB standards include a reference that the engagement was conducted in accordance with those standards. The rule replaces previously required references to GAAS. It also adopted technical amendments to its rules on interim standards that referred to existing professional standards of auditing, attestation, quality control, ethics, and independence. This standard is effective beginning May 24, 2004.
PCAOB Auditing Standard No. 2 (June 2004)	*An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* This standard addresses both the work that is required to audit internal control over financial reporting and the relationship of that audit to the audit of the financial statements. This standard is effective for audits of companies with fiscal years ending on or after November 15, 2004, for accelerated filers, or July 15, 2005, for other companies.
PCAOB Auditing Standard No. 3 (August 2004)	*Audit Documentation and Amendment to Interim Auditing Standards* This standard establishes general requirements for documentation an auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the PCAOB. This standard is effective for audits of financial statements of companies with fiscal years ending on or after November 15, 2004.

Recent PCAOB Rules

In addition to the standards discussed above, the PCAOB has also received SEC approval for numerous rules. The newly issued rules pertain to a number of topics, such as various amendments to the interim standards, terminology, oversight of non-U.S. registered public accounting firms, registration deadline for non-U.S. firms, inspections of public accounting firms, investigations and adjudications, registration withdrawals, and other matters. Auditors of public companies can stay abreast of these rulemaking activities by visiting the PCAOB Web site at www.pcaobus.org.

PCAOB Adopts Temporary Transitional Rule Relating to PCAOB Auditing Standard No. 2. On November 30, 2004, the PCAOB adopted a temporary transitional rule relating to PCAOB Auditing Standard No. 2 to facilitate the objectives of the SEC's Exemptive Order No. 34-50754, as described above in the "Complying With Sarbanes-Oxley Section 404—Internal Control Reporting" section. First, the temporary rule would permit auditors to date their reports on management's assessment of the effectiveness of internal control over financial reporting later than the date of their reports on the financial statements of companies relying on the SEC's Exemptive Order. Second, PCAOB Auditing Standard No. 2 provides that the auditor's separate report on the financial statements should include a paragraph that refers to a separate report on internal control over financial reporting. The temporary rule waives this provision for auditors in connection with their audits of companies relying on the SEC's Exemptive Order. The temporary rule will be submitted to the SEC for approval, as required by the Sarbanes-Oxley Act. If approved, the temporary rule will take effect immediately. By the rule's terms, it will expire on July 15, 2005. The Board's rulemaking release on the temporary rule can be found under Rulemaking Docket No. 016 on the Board's Web site, www.pcaobus.org. Readers should stay alert to any final SEC approval.

PCAOB Issues Implementation Guidance

The PCAOB has issued staff guidance on Auditing Standards No. 1 and No. 2 in the form of questions and answers (Q&As) documents:

- *Staff Questions and Answers: Audits of Financial Statements of Non-Issuers Performed Pursuant to the Standards of the PCAOB*
- *Staff Questions and Answers: Auditing Internal Control Over Financial Reporting*. These questions and answers consist of three separate sets—questions 1-26, questions 27-29, and questions 30-36.

These staff questions and answers documents can be obtained at www.pcaobus.org/Standards/staff_questions_and_answers.asp.

Interim Standards Available on Web Site

The PCAOB's interim auditing, attestation, quality control, ethics, and independence standards are now available on the Board's Web site. These AICPA-developed standards were adopted by the PCAOB in April 2003 for use in connection with audits of public companies. The interim standards, primarily as codified in the AICPA's *Codification of Statements on Auditing Standards*, can be found at www.pcaobus.org/Standards/index.asp.

Upcoming PCAOB Inspection Focus

Auditors of public companies should be aware that the SEC's chief accountant predicted in a recent speech that in the coming year the PCAOB will inspect audit firms for issues such as tax reserves, documentation, and derivative accounting.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. You should check the appropriate standard-setting Web sites (listed below) for a complete picture of all accounting and auditing projects in progress. Presented below is brief information about certain projects that are expected to result in final standards in the near future. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP, GAAS, or PCAOB standards.

The following table lists the various standard-setting bodies' Web sites, at which information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB) (Note that for audits of public companies, the Public Company Accounting Oversight Board sets auditing standards.)	www.aicpa.org/members/div/auditstd/drafts.htm
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.fasb.org
Governmental Accounting Standards Board (GASB)	www.gasb.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Auditing Pipeline—Nonpublic Companies

The proposed standards discussed in this section would not apply to the audits of public companies and other audits conducted under the standards of the PCAOB. Readers should keep abreast of the status of the following projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Seven SASs Related to Audit Risk Proposed

In December 2002, the AICPA's Auditing Standards Board (ASB) issued an exposure draft proposing seven new SASs relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards
- *Audit Evidence*
- *Audit Risk and Materiality in Conducting an Audit*
- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

The proposed SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. Readers should be alert for the issuance of final SASs in 2005.

Proposed SAS, *Communication of Internal Control Related Matters Noted in an Audit*

This proposed SAS will supercede SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), and significantly strengthen the quality of auditor communications of such matters in audits of nonpublic companies. Readers should be alert for the issuance of a final standard in 2005.

Proposed SSAE, *Reporting on an Entity's Internal Control Over Financial Reporting* (AT 501)

This proposed Statement will establish standards and provide guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). Specifically, guidance is provided regarding the following:

- Conditions that must be met for a practitioner to accept an engagement to examine the effectiveness of an entity's internal control and the prohibition of acceptance of an engagement to review such subject matter

- Engagements to examine the design and operating effectiveness of an entity's internal control

- Engagements to examine the design and operating effectiveness of a portion of an entity's internal control (for example, internal control over financial reporting of an entity's operating division or its accounts receivable)

- Engagements to examine only the suitability of design of an entity's internal control (no assertion is made about the operating effectiveness of internal control)
- Engagements to examine the design and operating effectiveness of an entity's internal control based on criteria established by a regulatory agency

Readers should be alert for the issuance of a final standard in 2005.

Accounting Pipeline

Proposed FASB Statement, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets—an amendment of FASB Statement No. 140*

This proposed Statement would amend and clarify FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, in several ways. The initial exposure draft for this proposed Statement was issued in June 2003. However, in response to several comment letters the FASB began redeliberations on the issues raised. Readers should be alert for the issuance of a revised exposure draft, which is expected to occur in the second quarter of 2005. The FASB will be issuing two additional exposure drafts pertaining to FASB Statement No. 140 also in the second quarter of 2005. The exposure drafts will pertain to beneficial interests in securitized financial assets and servicing rights. See the FASB Web site at www. fasb.org for complete information.

Proposed FASB Statement, *Share-Based Payment—an amendment of FASB Statements No. 123 and 95*

This proposed Statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and generally would require instead that such transactions be accounted for using a fair-value-based method. In October 2004, the FASB approved a six-month delay in the options expensing rule, to June 15, 2005. This accounting proposal is engulfed in highly charged political debate and as such the ultimate resolution of share-based compensation accounting remains uncertain. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, *Fair Value Measurements*

In June 2004, the FASB published an exposure draft of a proposed Statement, *Fair Value Measurements*, which seeks to establish a framework for measuring fair value that would apply broadly to financial and nonfinancial assets and liabilities, improving the consistency, comparability, and reliability of the measurements. The fair value framework would clarify the fair value measurement objective and its application under authoritative pronouncements that require fair value measurements. The exposure draft would replace any current guidance for measuring fair value in those pronouncements and would expand current disclosures. Readers should be alert for the issuance of a final Statement, which is expected to occur in the first quarter of 2005. Refer to the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statements Resulting From Short-Term International Convergence Project

In an effort to reduce or eliminate certain differences between U.S. GAAP and international financial reporting standards (IFRS), the FASB issued exposure drafts on the proposed FASB Statements listed below. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, *Accounting Changes and Error Correction—a replacement of APB Opinion No. 20 and FASB Statement No. 3*	This proposed Statement would change the reporting of certain accounting changes specified in APB Opinion No. 20, *Accounting Changes*, by requiring retrospective application of a newly adopted accounting policy for most changes in accounting principle, including changes in accounting principle required by issuance of new pronouncements. It would also require reporting of a change in depreciation, amortization, or depletion method as a change in accounting estimate. Readers should be alert for the issuance of a final Statement, which is expected to be released in the first quarter of 2005.
Proposed FASB Statement, *Exchanges of Productive*	This proposed Statement would eliminate paragraph 21(b) of APB Opinion No. 29,

Assets—an amendment of APB Opinion No. 29	*Accounting for Nonmonetary Transactions*, which establishes an exception to the general principle that exchanges of nonmonetary assets should be recorded at the fair value of the assets exchanged. This proposed Statement would require that exchanges of productive assets be accounted for based on the fair values of the assets involved, unless the exchange transaction does not have commercial substance. Readers should be alert for the issuance of a final Statement, which is expected to be released in the fourth quarter of 2004.
Proposed FASB Statement, *Earnings per Share—an amendment of FASB Statement No. 128*	This proposed Statement would amend the computations guidance in FASB Statement No. 128, *Earnings per Share*, for calculating the number of incremental shares included in diluted shares when applying the treasury stock method. Also, this proposed Statement would eliminate the provisions of FASB Statement No. 128 that allow an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in stock. In addition, this proposed Statement would require that shares that will be issued upon conversion of a mandatorily convertible security be included in the weighted-average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory. Readers should be alert for the issuance of a final Statement, which is expected to be released in the fourth quarter of 2004.

Proposed FASB Interpretation, *Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143*

This proposed Interpretation would clarify that a legal obligation to perform an asset retirement activity that is conditional on a future event is within the scope of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*. Readers should be alert for the issuance of a final Statement, which is expected to occur in the fourth quarter of 2004. Refer to the FASB Web site at www.fasb.org for complete information.

Industry-Specific Projects

The following industry-specific accounting projects are in progress. Readers should refer to the relevant AICPA industry Audit Risk Alerts for further information.

- Proposed SOP, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. A final SOP is expected to be issued during the first quarter of 2005.
- Potential SOP, *Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97*. A revised exposure draft is expected to be issued during the fourth quarter of 2004.

Proposed FASB EITF Issues

Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

Proposed FASB Staff Positions

A number of proposed FASB Staff Positions are in progress addressing issues related to FASB Statements No. 140 and No. 142 and EITF No. 03-1. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

This Audit Risk Alert replaces the AICPA general *Audit Risk Alert—2003/04*. The general *Audit Risk Alert* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to rdurak@aicpa.org, or write to:

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